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# FORTUNE

## CEO PAY

**How to  
Do It  
Right**

*Goodyear CEO Stanley C. Gault (left) heads the compensation committee of the Avon board, which approved an innovative pay plan for CEO James Preston.*

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# FORTUNE



**ABOVE:** Stanley Gault and James Preston are two CEOs who have aligned their interests with those of shareholders. Photo by Hans Neleman.

**COVER:** Neleman found Gault and Preston at a board meeting at Avon's corporate headquarters in New York City.

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As their compensation gallops relentlessly upward, America's corporate brass are feeling the heat of public outrage. Look for politicians to play up the issue in the primaries and beyond. If CEOs can't devise plans that link pay to performance, Washington may take a whack at it. *by Geoffrey Colvin*

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## EDITOR'S DESK



Colvin: Reward CEOs for success; punish them for failure.

**W**HEN the Kellogg School of Business at Northwestern University set up an all-day seminar for dozens of chief executives, corporate directors, and compensation consultants on the hot-button subject of CEO pay, organizers asked senior editor Geoffrey Colvin to be a key speaker. A good choice: He has supervised our coverage of CEO pay for the past five years.

Colvin told the Kellogg audience—members of 180 corporate boards were present—just what he reiterates in our cover story beginning on page 60: The method by which top executives get paid is out of whack. What is needed is a plan that gives them a true incentive to succeed but also makes them—and their board members—accountable for failure. Says Colvin: "The problem is that directors buy a chief executive's services, but the shareholders pay for them. That can often lead to trouble."

Don't say we didn't warn you. When

FORTUNE took a hard look at executive compensation in 1988, we said the issue could erupt into a full-blown controversy unless companies devised a more equitable way to pay their top bosses. Recalls Colvin: "We took a lot of guff on that one. People were convinced that Washington would never get involved, that this would not become a bare-wire issue."

But it has, and the notion that chief executives are ripping-off shareholders is now a highly charged topic in Washington, on Wall Street, and in corporate boardrooms. Several U.S. Congressmen have proposed legislation to regulate executive pay. The Securities and Exchange Commission is considering action. Colvin realized just how concerned top corporate brass have become when he surveyed his

Northwestern audience urgently trying to figure out what to do. Our story may help be a guide. Look too for our annual compilation of CEO pay at 200 top companies, coming later in the spring.

About a year ago, writer Patricia Sellers began pestering executives at Philip Morris for an interview with the newly named CEO, Michael A. Miles. Rebuffed repeatedly, she kept calling until Miles agreed. Her in-depth report, based on interviews with scores of industry executives in addition to Miles, analyzes some surprising problems at the world's largest and most profitable consumer products company.

### Sellers: Be persistent.



*Marshall Loeb*

MANAGING EDITOR

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MANAGING/COVER STORY

# HOW TO PAY THE



# CEO RIGHT

As the furor widens, America's business chiefs and corporate boards can fix the system—or let Washington whack at it. ■ *by Geoffrey Colvin*

**C**EOS ARE PAID a lot to face facts, however unpleasant, so it's time they faced this one: The issue of their pay has finally landed on the national agenda and won't be leaving soon. It is now inevitable that someone will do something about it, and one of the fiercer dramas of the next several months will feature Congress, the Securities and Exchange Commission, the accounting profession, and the CEOs themselves battling over who that someone will be. The fight has already begun.

Anyone can tell you what the problem is. Just ask your neighbor or cabdriver—then stand back. Largely unharnessed from corporate performance, the pay of America's CEOs has been galloping forward faster than the average production worker's pay, faster than corporate profits, industrial production, the national debt, the population of India, channels on cable TV, or just about anything else on earth but the number of newly independent republics. The CEOs of 282 large and medium-size U.S. industrial companies studied by the Hay Group consulting firm earned, on average,



The SEC's Breeden is giving shareholders greater say in setting pay.

\$1.7 million in total compensation last year; in the 30 largest, some \$3.2 million.

Maybe if the economy were thriving and big employers were hiring, no one would care. Maybe if President Bush hadn't taken the auto company CEOs to Japan to meet their lower-paid, more successful competitors, or if consumer confidence weren't in the tank, or if giant companies weren't still announcing vast layoffs, CEO pay wouldn't be on the front pages. But all those things have happened, making Americans deeply, bitterly mad and creating an issue no politician can resist. When a conservative, like Dan Quayle rails against "those exorbitant salaries paid to corporate executives unrelated to productivity," something's up. The issue should only get hotter as proxy statements detailing executives' 1991 compensation go out to shareholders in the next few weeks, about the same time as several of the most important primary elections.

The Securities and Exchange Commission, among the first to act, recently reversed its long-standing practice by allowing shareholders a nonbinding vote on corporate pay policies. The commission is considering requiring fuller disclosure of executive pay in proxy statements, and Washington could go still further. SEC Chairman Richard Breeden says, "God only help us if the government gets in the business of trying to regulate compensation. It is the board of directors' job, and I would warmly and strongly recommend them to please do it—because if they do not, then someone will call on us to do it."

Who's to blame for all this? That's easy: CEOs. A pedant might insist that boards of directors are the culprits, since they set top executives' compensation. But in practice most CEOs

appoint their own directors, presenting only their nominees to the shareholders for a vote. Besides, 63% of all directors are CEOs. Face it, fellas: You got yourselves into this mess. Now it's time to get yourselves out.

Fixing CEO pay is a two-level challenge. Level one is devising a pay plan that works; many innovative companies—Georgia-Pacific, Avon Products, Becton Dickinson, and several others—are exploring new ways to link pay and performance. Level two—much harder to reach—is getting boards of directors to adopt those smart pay plans instead of the stupid ones they so often favor.

The bedrock principle of paying the chief is aligning his interests with the shareholders'. Sounds simple enough. But the favorite instrument for doing that over the past 40 years, the beloved stock option, turns out to be full of problems. That fact guar-

REPORTER ASSOCIATE Stephanie Losee

## JAMES PRESTON

CEO, AVON

- Has salary frozen at \$610,000 until retirement.
- Has cut in target bonus from 65% of salary to 50%.
- But gets one-time grant of options on 50,000 shares.



## T. MARSHALL HAHN

CEO, GEORGIA-PACIFIC

- Instead of stock options, will receive grants of stock—but only as the share price rises.
- Must hold all shares received for at least five years.

ger in a game of craps called 'the market.' "

The CEO with options has another advantage over the ordinary investor: inside information. Knowing the company's prospects more intimately than anyone, he has a far better chance of choosing a peak in the stock price to exercise options and take his profit. There's nothing illegal about this. That's just the way it is.

And that is how options work when companies play fair. Many play otherwise. Suppose a company issues options to a CEO when the stock is at \$50, and it then falls to \$30. You might think it's only right for the optionee to be out of the money in that case, but some compensation committees instead take pity on him. They cancel those options and replace them with new ones at \$30.

America's champion option repricer is Apple Computer. "They're worldclass," says Ralph Whitworth, president of the Washington shareholder rights group United Shareholders Association, with bitter admiration. Apple has repriced executive stock options six times since 1981.

antees conflict ahead, because options have been the main engine powering the hypergrowth of CEO pay since the Eighties. In 1985 the typical CEO of a fair-size American industrial received long-term incentives, mainly options, with an estimated value of \$58,000. Last year it was over \$527,000. Base salary, bonus, perks, benefits—each figures in, but not like options. They are the form of compensation getting the closest scrutiny from Congress, the SEC, and the accounting profession.

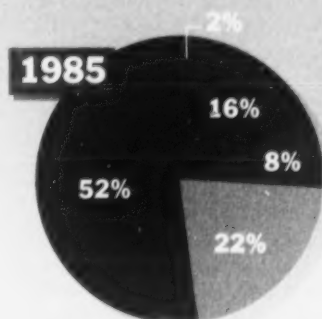
A standard option gives an executive the right but not the obligation to buy company shares for ten years at the market price on the day the options were granted, though usually he must wait two to four years before he may exercise them. The incentive seems straightforward: The executive will work like mad to maximize his wealth by raising the stock price, and shareholders get the benefit.

Trouble is, it doesn't work very well. Options can be employed intelligently and effectively. But because they have built-in flaws and are often abused, their record of linking executives' interests with shareholders' is far from good. One reason is that the optionee doesn't put up any money. For

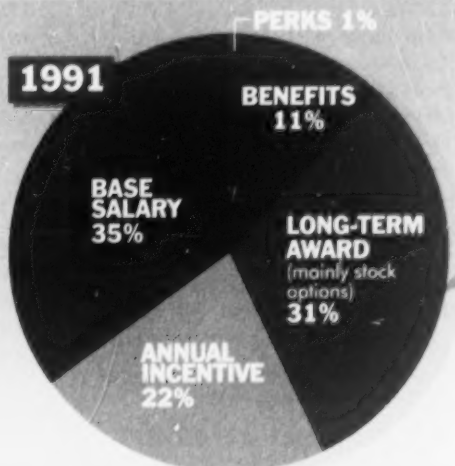
most ordinary investors, the fear of loss is at least as strong a motivator as the hope for gain, but recipients of options face no risk. If the stock rises, terrific; if it falls, they simply discard the worthless things. As compensation consultant James F. Carey puts it, "From the participant's viewpoint, the option grant may seem like a no-risk wa-

### HOW CEO PAY HAS GROWN

At 282 large to medium-size industrials



\$725,000



\$1,700,000

with two repricings affecting options held by CEO John Sculley. As a result, he has earned gains on those options before investors who stayed with the stock earned a dime. Venture capitalist Peter O. Crisp, chairman of the compensation committee of Apple's board, won't comment on the repricings.

The bottom line is that when compensation expert Graef S. Crystal examined the option gains of 281 CEOs vs. the performance of their companies' stocks in the 1980s, he found scant correlation. Chief executives could often wring substantial option gains out of shares with merely middling long-term performance. In short: Options on average do not put CEOs in the same boat as shareholders, or even in the same body of water.

So why do boards of directors award them in such superabundance? Mostly for a few reasons, none of them good but all of them powerful. One is the near-magical way options are treated in a company's financial statements. Pay a CEO in cash, and that money becomes an expense that reduces profits. But give him a stock option, even a mammoth option that may one day pay him tens of millions, and under the rules of accounting, reported profits do not decline 1 cent as a result. On the corporate income tax return, however, options do have an effect: They eventually create a deduction if they turn out to be worth something. When an employee exercises his options, tax rules recognize that his gain is value the company has given away—after all, it could have kept those shares and sold them later at a higher price—so it is tax deductible.

**A**NOTHER extraordinary feature of options is that their value is almost never fully reported to shareholders. Stock options most assuredly have value, even though any option's precise payoff is uncertain until it is exercised. A company's annual proxy statement reports top-executive option grants but gives no hint of what those options might someday be worth—a value that can be estimated through several techniques. Yes, the proxy will also report the CEO's gain when he exercises options, but only if he is still an officer.

Consider a few related facts: Most op-

tions are good for ten years; most CEOs hold that job for less than ten years; most options can be exercised for three years or more after an optionee retires. Shareholders never know about most of a CEO's option profits because he takes them after he is no longer an officer.

Now imagine you're a corporate director when profits are under pressure and CEO pay is a bare-wire issue. At the February board meeting do you vote the CEO an extra million dollars in salary and bonus, which will reduce profits and increase his

compensation as reported in the proxy statement? Or do you give him options that are worth perhaps two or three times that much, will not affect profits, may reduce the company's taxes later, and will not show up as a dollar amount in the proxy? This may be where the phrase "no brainer" originated. All in favor say aye!

If the financial treatment of stock options seems crazy to you, you're not alone. The SEC, Congress, and the rulemakers of accounting have all recently begun considering changes that would wipe out the striking attractions of options. And many CEOs are *steaming*. At the top levels of giant companies, meddling with the boss's pay is known as "playing with the sheriff's daughter."

SEC Chairman Breeden has directed his chief accountant to report by mid-June on ways companies might be required to calculate a dollar value for option grants, which would be reported in proxy statements. Some of these valuation methods make your temples throb, but a rough rule of thumb for ordinary ten-year options is to take the grant's face value—number of shares times exercise price—and divide by

## JAMES SUTTON

CEO, UGI

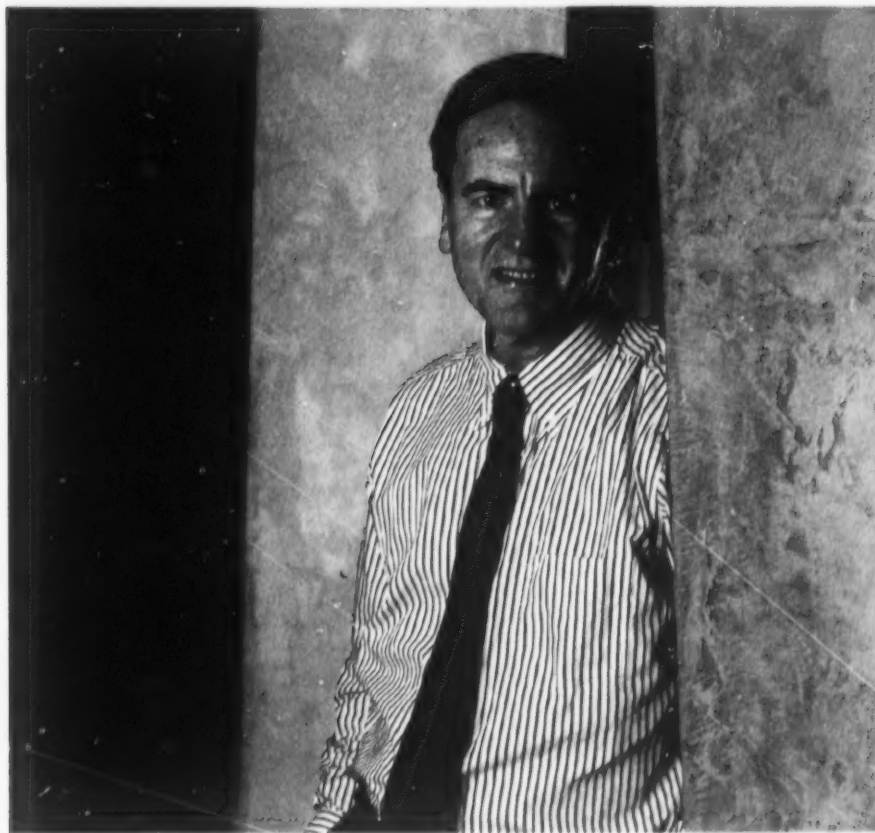
■ Received just one grant of stock options in five years.

■ Earned dividends only if company beat peers.

■ Raised UGI from No. 23 to No. 2 in total return.



Sutton, left, and compensation committee chairman Robert C. Forney, a recently retired Du Pont executive, plan to renew UGI's successful five-year pay program this spring.



three. Senator Carl Levin (D-Michigan) has introduced a bill that would, among other things, make companies value option grants and reduce reported profits when they award them, just as when they award other forms of compensation.

Much more significantly, the Financial Accounting Standards Board, which sets accounting rules, has just shoved to the front burner a long-simmering project on the treatment of options. If the board concludes—as it well may, and should—that giving options involves an expense, the effect on CEO pay could be enormous. The directors' no-brainer isn't so simple anymore. Financially, options are the one big freebie in the world of pay, since you can award all you like and never reduce reported earnings. But if the accountants start charging for them, you can be certain companies won't use them as much. It is even conceivable that some CEOs' pay could go down.

If you think CEOs don't worry much about this technical accounting stuff, consider what happened the last time FASB tried to tackle the issue of options, in the mid-1980s. It never even got a chance to write a proposed rule. Scores of high-pow-

## JOHN SCULLEY

CEO, APPLE COMPUTER

■ **Has had his options swapped for lower-priced ones.**

■ **Has earned gains on these before investors who stayed with the stock made anything.**

ered CEOs—"not the people who normally write in on accounting matters," recalls a former board member—came down like a ton of bricks with strongly worded letters, many not bothering to give reasons, according to people who have read them. The simple message: *Drop it.*

FASB tabled the matter for four years in favor of others it decided were more important. And this time? "The forces of opposition have not quite been marshaled yet," said FASB Chairman Dennis Beresford on the day the board stepped into the ring for Round Two. "But they will be."

And where will these forces come from? One place to look is the Business Roundtable, the club of CEOs from 200 of America's largest companies. It has been feuding with FASB for years and lost no time staking out a position on this issue. Executive stock options, it believes, are just about the greatest thing for America since microwave popcorn. In a statement so audacious it makes one's head swim, the Roundtable claims that the bull market of the 1980s is proof that stock options work. Options did multiply enormously in those years, but most compensation consultants say cause and effect were just the opposite: Boards saw the market taking off and jumped to ladle out more options.

**T**HE WHOLE IMBROGLIO is a shame, because options, for all their problems, *can* be useful incentives if adapted and applied with rigor. Directors courageous enough to demand real performance from a CEO can, for example, index the option's exercise price to some target return they want to beat—the stock market's, an industry peer group's, or the rate on Treasury bills, for example. Becton Dickinson, the New Jersey medical technology company, did that last year when it adopted a plan that sets executive option prices for the next four years according to the performance of the S&P 500. The board grants options each May, and if the S&P has outperformed the stock since the last grant, then the exercise price of new options is set higher than the actual share price. That will give CEO Raymond V. Gilmartin and his top officers a windfall if Becton stock has beaten the S&P but will leave them struggling to catch up if it has fallen behind.

That element of risk tied to the stock's performance is key to effective CEO pay, say most compensation consultants. A little imagination can find all sorts of ways to create it. One, similar to indexing but simpler, is to set an option's exercise price way above the market and then just sit back and watch the CEO try to beat it. The best example is the 1.8-million-share option granted to Time Warner co-CEO Steven J. Ross two years ago at \$150 a share when the stock was at \$118. The grant could still earn him a vast sum, but with the stock currently around \$105, Graef S. Crystal calculates there's about a 40% chance it will never earn him a thing.

Another effective way to add risk is to substitute some form of stock compensa-

tion for cash. That's still unusual; the story of CEO pay over the past few decades is a tale of clever but riskless incentive plans piled ever higher as consultants thought them up. Each one, intended to motivate the CEO afresh, simply tossed him another no-lose way to make a bundle. But taking away old-fashioned cash and putting some form of risky stock in its place—that focuses the mind.

Avon has just done this in a new plan to be described in its proxy statement due out any day now. CEO James Preston, working with Goodyear CEO Stanley C. Gault, who is chairman of Avon's compensation committee, came up with a plan that freezes Preston's base salary for the rest of his career—he'll be 65 in seven years—at \$610,000 annually. His target bonus had been 65% of that but is now reduced to 50%. In return for giving up seven years of raises, which at a modest 10% annually would have lifted his salary to nearly \$1.1 million by retirement, plus giving up part of his bonus, he gets a one-time grant of options on 50,000 shares.

Because Preston's salary is frozen, those options have a hurdle built in. Preston has been telling the world that Avon can increase profits 10% to 12% annually for the next three to five years. If that happens, and the stock rises in tandem, then Preston's gain on his options will merely equal what he gave up in expected raises and bonuses. In other words, to come out ahead, Preston will have to beat his own projections for the company.

That's incentive. Note that the plan is not fancy. Yet it more than satisfies major institutional shareholders who have been ticked at Avon for beating back four takeover attempts in three years. Preston meets twice yearly with representatives of these shareholders, and Ralph Whitworth of the United Shareholders Association came to last November's gathering "loaded up to talk about compensation," he says. But Preston preempted the attack by announcing his new pay plan first.

"Jim and I have talked about compensation for years," says Gault. "At Goodyear the vast majority of my reward will be directly tied to stock. It's not a surprise that Jim would want his compensation on this basis." Preston explains how the plan has affected him: "I have an incredibly vested interest in shareholder value. My focus is on making myself and thousands of others wealthy."

To see a sophisticated and effective use

of options, check the pay plan at UGI, a diversified gas and electric company in Valley Forge, Pennsylvania. When James Sutton took over as CEO in 1986, UGI ranked 23rd in a group of 23 peer companies on the basis of total return to shareholders over the previous five years. To turn things around, Sutton and his board decided to replace a jumble of long-term pay plans with a single option plan.

He and his top officers would get option grants, and then no more options for five years. During that time the substantial dividends associated with the option shares would be placed in a special account for each officer. After the five years—which ended last December 31—the officers could get their dividends according to how UGI ranked in its peer group based on five-year total return. If it ranked No. 10 or below, they would get nothing; if No. 7 through No. 9, they would get 50% of the dividends; if No. 2 through No. 6, 100%; and if UGI ranked No. 1, they would get 160%.

## WILLIAM P. STIRITZ

CEO, RALSTON PURINA

- Was offered \$16 million of stock if price rose 60%.
- Took five years to hit target.
- Received reward for a performance that fell short of industry average.



When the big day came, UGI ranked No. 2 (after Indiana Energy), with a five-year compound average annual return of 17.2%—far better than the stock market. Sutton collected \$1.5 million. After paying taxes, he invested the rest in UGI stock. All his top officers did the same. "We wanted a high-risk, high-reward plan," he says. "It caused us to take a long-term view. Every time we looked at a major project or strategic decision, we ended up reducing it to shareholder value."

**G**EORGIA-PACIFIC recently adopted a different sort of stock-based incentive. At the instigation of CEO T. Marshall Hahn Jr., the company abandoned stock options for top officers in 1988, replacing them in 1990 with outright grants of stock carrying some tight restrictions. If the stock rises 20% from a \$50 base (about \$8 higher than the actual price when the program started) and stays at that level for 20 consecutive trading days, the officers get 20% of their grants. If it rises 40% and stays there for 20 straight days, they get 40%, and so on. After five years the program ends and the officers can receive up to 100% of their stock grants—if the stock has doubled. They must hold for at least five years whatever stock they get. Wall Street analysts who follow the struggling paper industry like the plan. Says Chip Dillon of First Manhattan: "It gives management more incentive to do what's in the interests of the shareholders."

Design such a plan without sufficiently high hurdles and you're asking for trouble. Ralston Purina's board told CEO William P. Stiritz and his top officers in 1986 that if they could get the stock up 60%, they would collect large helpings of it. The job took five years, and Stiritz collected \$16 million of shares for a performance that barely exceeded the market's and failed to match the food-processing industry's. The plan did exactly what a good plan shouldn't: pay big for subpar performance. Stiritz won't talk about it, but Ralston has said in a prepared statement that the plan "was appropriate for the company at the time and has achieved cost-effective results."

The common element in well-designed plans is getting a lot of stock into the CEO's hands and making sure it costs him. It could cost him years of raises, as at Avon, or it could cost him a pay cut. That's what happened at International Multifoods in Min-

## MANAGING

neapolis, where CEO Anthony Luiso asked the board to trim his cash compensation by \$200,000 a year for five years in return for stock options of equal value.

Such reforms could even cost the CEO money out of his checking account. A number of compensation experts think a smart board might simply set a stock ownership goal for the CEO and tell him to reach it any way he wants—by exercising old options or by calling up his broker. In any case, whenever a CEO exercises options the board should insist that he sell only enough of the shares to pay the taxes—and hold the rest. That doesn't just sound like common sense; it also is in sync with research by consultant Ira Kay of the Hay Group, who has found that the more of his company's stock a CEO owns, the better the company performs.

But wait. Isn't this just a bit draconian, making the CEO live and die by the stock? After all, researchers have shown that most of a stock price's movement results not from the actions of managers but from the movement of the market. Is it really fair to make a good, hardworking corporate chief suffer when the inscrutable market moves against him?

Sure it is, say investor rights advocates, who point out that when the stock goes down, investors suffer and employees often suffer, so why shouldn't the CEO suffer too? A better response is that "suffer" is perhaps not the *mot juste* here. No CEO of a large American company is going to suffer, as most people would understand that term, no matter what the stock does, thanks to two little items called base and bonus. In major companies these generally furnish a million or two annually to keep body and soul together no matter how chill the wind on Wall Street. Preston of Avon, whose base salary is barely average for a company with sales of \$3.6 billion, maintains a wry sense of perspective on the matter: "I have a safety net of \$610,000, and believe me that's more than adequate. My family and I have agreed that no matter what happens, we'll squeak by."

In truth, salaries are not much of an issue in the furor over CEO pay. They account for only about one-third of total compensation, and finding one much above \$1 million isn't easy. That's a lot of money, but it won't get you on a magazine cover or denounced on the Senate floor.

Bonuses are another matter. The practice of awarding them "at the discretion of the board" is an invitation to negate all the

## AND ABROAD?

Across America the cry was inescapable as President Bush led all those CEOs on his ill-starred January tour of Japan: *Our guys make three times more than theirs—and look who's eating whose lunch. It's a scandal!* The U.S. executives were prepared with their riposte: *Don't be fooled. These Japanese CEOs get enough perks to make Queen Elizabeth weep—and their value is never reported.*

What's the truth?

The truth, in a sentence, is that Japanese and other non-U.S. CEOs do get perks by the truckload—the use of company-owned homes and vacation retreats, club memberships—but their value does not close the pay gap by a long shot. Conventional wisdom holds that this is a cause of America's competitiveness problems. But while runaway pay dissipates workers, there's no reason to think that just cutting it will, by itself, do much for U.S. competitiveness. Why not? The situation is analogous to that of the U.S. students who ranked near the bottom in an international survey of math skills but had the No. 1 opinion of themselves. In a system in which CEOs appoint their companies' directors, most of whom are other CEOs, pay is precisely the expression of what CEOs think of themselves. Like U.S. students, they should recalibrate their self-image. But that won't help the country unless they also perform better.

What's true for companies is true for countries: If the U.S. were beating the pants off its rivals, hardly anyone would care what its CEOs got paid. That's why just paying less isn't the answer, and paying for performance is.

good intentions of a pay-for-performance plan. To avoid this, many companies set explicit targets—for earnings, return on assets, or some other measure—that will trigger a bonus, and stick to them. At UGI, James Sutton received no bonus in 1990 or 1991 because abnormally warm weather cut demand for gas and electricity, which clobbered earnings per share. Is that fair? "Life isn't fair," he shrugs.

Varying this approach, some boards set the bonus as a flat percentage of profits.

Reebok famously did this for CEO Paul Fireman when the company was tiny, and as it mushroomed his bonus did too—alarmingly—exceeding \$15 million in 1987. Disney CEO Michael Eisner gets a profit-based bonus, \$4.7 million in fiscal 1991. So does Time Warner's Steve Ross. While the 1991 amount hasn't been announced, it will be larger than last year's \$2 million because operating profits were higher.

The danger in the focus on profits is that it zooms in on just one accounting measure, one that a clever CEO may be able to manipulate, perhaps to the detriment of the company. It may be "too easy to kite," as Stanley Gault says. So there's no easy, mechanical approach to calculating bonuses; fickle as the board's judgment may be, you've got to rely on it.

**W**HICH LEADS to the great big question in the world of CEO pay: How do you get the board to do the right thing? Even if you devise the most brilliant compensation plan ever, why should the directors adopt it? Because their job is to discipline management for the good of the shareholders? Remember that effective CEO pay plans always involve a hefty risk—something many CEOs, like most other people, don't like. Remember also that CEOs in essence appoint the directors to their prestigious positions and usually recommend their pay. These directors are not naturally eager to hold the CEO's feet to the fire on compensation. Note that not one of the well-designed pay plans cited here was imposed on a CEO by his board. On the contrary: In each case a confident CEO approached the board saying, "I'm willing to take on more risk if you'll give me a shot at some extra reward." Such cases are rare.

Countering the temptations for a director to go easy on CEO pay are a few building pressures to get tough. One is the threat of legal action. Directors seldom get sued for overpaying the CEO, but it happens, and in the current climate it could happen more. Fairchild, a miniconglomerate built around the old Fairchild Industries, last year settled a shareholder suit alleging that directors overpaid CEO Jeffrey J. Steiner. His salary and bonus totaled \$6 million in 1990, when the company earned only \$1.5 million. The settlement cuts Steiner's salary, restricts his bonus for five years, and cancels options on 50,000 shares.

Institutional investors, the wakening

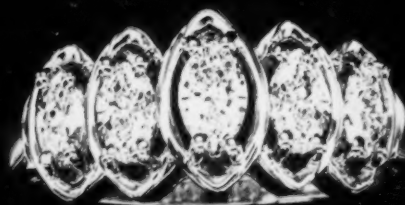
900-pound gorillas of corporate life, are turning their attention to CEO pay. A group of them, including the formidable California Public Employees Retirement System (Calpers), last year went after ITT and won its agreement to tie CEO Rand Araskog's pay more closely to the performance of the stock. That was only one company, but the ugly publicity it endured has probably frightened many others into changing their ways.

As the public grows more fascinated by CEO pay, the threat of personal embarrassment or shame may be one of the strongest forces building up on directors. Time was when they scarcely had to explain their actions to anyone. But when Mike Wallace pushes a microphone under your chin, you'd better have something to say.

**L**ESS CONCRETELY but just as certainly, the spirit of the times is having its effect. These are the frugal Nineties, and directors can feel it. The zeitgeist has often influenced CEO pay, which hasn't always advanced at its recent breathtaking clip. A couple of decades ago it increased more slowly than the pay of factory workers. Jude Rich of Sibson & Co., one of America's most respected compensation consultants, says the bull market in pay that's still going on began around 1975. That was a time when the larger culture was throwing off self-restraint everywhere. Significantly, it was also around the time federal courts freed baseball players from indentured servitude by invalidating the reserve clause. Don't laugh: Many pay experts agree that when 20-year-old shortstops started making more than CEOs, everything changed.

If pay practices are improving now, it's because CEOs and directors are feeling the heat of public outrage. It should burn steadily through the proxy season, and the presidential election will keep it alive for a while afterward. And then? Real reform, if it's to happen, will have to occur hundreds of times in boardrooms across the U.S. That is necessarily a touch-and-go proposition. Revolution may seem to be in the air, but never underestimate the power of chief executives who would really rather not change the way they're paid. Like CEOs, the rest of the country must face facts, however unpleasant: If a recovering economy or some other issue quenches the outrage and eases the pressure, there's no assurance that anything significant will change at all. **F**

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# STILL MAKING OUT ON WALL STREET

The booming stock market has investment bankers pulling down seven figures again. But some wise folks are trying to bring reason to an unruly compensation process. ■ by Ford S. Worthly

**I**F CEO COMPENSATION seems irrational, consider how Wall Street pays itself. In the year before Drexel Burnham Lambert declared bankruptcy, the firm forked over \$151 million in bonuses it had guaranteed to 60 bankers and other employees.irate creditors are now dunning the bonus babies for the money. Says a former senior officer of the firm: "No longer was pay related to performance."

At a Valentine's Day meeting with security analysts, Warren Buffett, interim chairman of Salomon Inc., described the haphazardness that typified pay policies at Salomon under the former management. "Prior to this year," he said, "there has been no understanding at all as to how compensation would eventually be determined at the end of the year . . . It was essentially a system where the year went along and people tended to quite understandably argue for whatever yardstick . . . worked best for their particular case, which is exactly what I would have done under the circumstances."

The dueling yardsticks kept pay and performance apart at Salomon, as they do regularly at other firms on Wall Street. Salomon's profitable departments, for instance, typically subsidized poorly performing ones like investment banking, whose professionals received millions of dollars in "bonuses" for bringing in large revenues but meager earnings. Just as out of whack is the relationship between the money some Wall Street firms shovel out to employees and the earnings they retain to compensate shareholders for the use of their capital.

In 1990, Sibson & Co., a leading compensation consultant, conducted an analysis

REPORTER ASSOCIATE Joshua Mendes

## TOTAL COMPENSATION: SALARY AND BONUS

| POSITION                          | JUNIOR PROFESSIONAL<br>(3-5 years' experience)<br>in thousands | SENIOR PROFESSIONAL<br>(10+ years' experience)<br>in thousands |
|-----------------------------------|----------------------------------------------------------------|----------------------------------------------------------------|
| Stock research analyst            | \$150-\$250                                                    | \$350-\$500                                                    |
| Bond trader                       | \$300-\$500                                                    | \$650-\$850                                                    |
| Corporate finance generalist      | \$250-\$400                                                    | \$700-\$1,000                                                  |
| Merger and acquisition specialist | \$250-\$400                                                    | \$750-\$1,200                                                  |
| Institutional bond salesperson    | \$200-\$300                                                    | \$600-\$800                                                    |

of major securities firms. The results showed that in the second half of the 1980s, a period in which Wall Street profitability went from outperforming to underperforming the rest of corporate America, the firms nonetheless allocated a progressively larger share of their booty to employees as compensation rather than to shareholders as profits. Why? The industry did not exercise enough "discipline," says Richard Fisher, chairman of Morgan Stanley, one of Wall Street's biggest firms.

The wrenching recession that eliminated one of every five Wall Street jobs and one out of every five firms that existed in 1987 did impose a fleeting self-control on the financial community. But then the market took off in 1991—

and so did pay. Following a stupendous year, compensation at many firms shot up 25% to 35%, pushing many senior corporate finance professionals well above the \$1 million mark and experienced bond traders into the

\$650,000 to \$850,000 range—not far below what they earned in the greedy mid-1980s. Mind you, those figures are merely averages.

Why is it that trading bonds or underwriting stock pays so richly compared with making cars or writing articles about million-dollar MBAs on Wall Street? Because the money is there and salaries are set by a ruthlessly competitive market. This is venture capital paid by a firm to retain performers who can expand market share or increase profits while competitors circle overhead ready to swoop down and carry off anyone who thinks he or she is underappreciated. Invariably, when a company starts offering fat guarantees or other enticements to keep or lure someone, other employees demand similar treatment, and the firm's overall compensation system begins to fragment. The link between pay and performance grows ever weaker.

The link has long been tenuous because few firms know how to measure performance well. Return on equity is one of the best yardsticks. The calculation seems straightforward: total annual profits generated by a given business, divided by the amount of equity capital that the company



Buffett: dueling yardsticks

## MANAGING

has invested in the business.

Pinning down profits, the numerator in this simple ratio, is difficult because the typical business unit within a Wall Street firm does not stand alone. Directly and indirectly, it depends on other operations throughout the firm. And all of them want credit for bringing in the same fees. Could the investment banker have landed that stock underwriting without the research department, whose security analysts first spotted the opportunity because of their knowledge of a particular industry?

Trying to get a handle on the denominator—how much equity should be allocated to each business within a firm—is even dicier. A mergers and acquisitions team selling its advisory services to a client might not need much capital itself, yet the success of a deal may depend on others who do: say, traders willing to buy and sell the debt issued to finance a takeover, who consume capital the way teenage boys do food.

Moreover, the equity attributable to a particular business should be adjusted to reflect the fact that some activities within a firm are riskier than others. And because risks change—frequently and sometimes significantly in the case of trading sophisticated financial instruments—the equity ideally ought to be reallocated almost constantly, rather than, as is the current practice, once a quarter or once a year or not at all. According to Charles Bralver of Oliver Wyman & Co., a consultant to the banking and securities industries, some Wall Street firms implicitly factor in this flux when measuring the performance of individual business units, but few do so explicitly or consistently.

The consensus is that Morgan Stanley and Merrill Lynch manage measurement issues better than most other firms do. Merrill Lynch's standards for judging performance reflect an unusual devotion to weighing the relative risks inherent in different businesses. The company regularly analyzes its reasonable worst-case exposure to loss in about 60 different activities, including those like interest rate swaps that require off-

**Merrill's Allison: He is making the paycheck reflect performance.**

balance-sheet capital commitments.

The firm sees to it that the business unit has enough capital to survive such a loss, increasing (or decreasing) the equity account as necessary. Individual units are expected to aim for the same 15% after-tax return on this "risk-adjusted" equity. By putting all units on the same footing, Merrill can compare the performances of different businesses more effectively.

Merrill Lynch has also been working hard to yoke the interests of the employees and the shareholders. Two years ago chief financial officer Herbert Allison devised an incentive pay plan that promised employees payments, in addition to their regular bonuses, that depended on how much the company advanced toward a targeted return on equity of 12.5%. Since few at Merrill imagined that the firm would come even close to that level, the special payments were immediately ridiculed as "Herbies." A tin can labeled Herbies was presented to Allison

bearing a warning that read "Important: Open only when Merrill Lynch makes our ROE goal. Don't hold your breath." Last year the firm turned in a roaring 21% return on equity, and those Herbies became known as "Mr. Allison's." Though Herbies no longer exist, Merrill Lynch incorporated the same link between bonuses and the firm's ROE into its broader incentive compensation plan.

Morgan Stanley maintains a consistent relationship between the share of the perfor-

mance pie that goes to employees as compensation and that which goes to shareholders in the form of dividends or retained earnings. If you think of the pie as what's left after all expenses except taxes and compensation are deducted from revenues, employees typically get two-thirds and shareholders and the tax collector the other third. That split has produced annual returns on equity that are among the highest in the industry, about 25% on average since Morgan Stanley went public in 1986.

The nature of compensation is also changing. Bear Stearns, Morgan Stanley, Salomon Brothers, Smith Barney, and many other firms now pay professionals

anywhere from 5% to 50% of their total compensation in restricted stock, which cannot be sold for up to five years.

Salomon hopes to restore symmetry to compensation through bonuses that more closely reflect performance—or lack of it. In January, chief operating officer Deryck Maughan asked Salomon's senior managers to "take the downside" risk if they fall short of specific goals agreed upon at the outset of the year, in return for the chance to earn vastly higher bonuses if they perform well. Roughly 150 top managers will now be exposed to potentially huge swings in compensation. Maughan suggests that this year these "partners" could "see their incomes coming in at a third of what they have been, or double what they have been."

For a clue to how effective Wall Street's compensation practices may be at rewarding and retaining valuable professionals, keep your eye on Salomon, which has lost droves of employees since Warren Buffett began overhauling the firm and the way it pays people. In particular, watch Lawrence Hilibrand, 33, a fixed-income arbitrage specialist. In 1990 the high-tech trading department he headed reportedly took in \$400 million in pretax profits. Hilibrand personally received \$23 mil—his share of an alluring commission deal that supposedly gave his group 15 cents for every dollar in pretax profits it produced. Buffett has described him as the closest thing Salomon had to a .400 hitter that year. But will Hilibrand remain with Salomon, for whom he has worked since 1980, or will competing firms successfully tempt him away with fat guarantees, all-cash bonuses, and sky-is-the-limit payoffs for every additional buck he brings to the bottom line? If money talks, will he walk?

**"Important:  
Open only  
when Merrill  
Lynch  
makes our  
ROE goal.  
Don't hold  
your  
breath."**

# CAN HE KEEP PHILIP MORRIS GROWING?

Mike Miles rode into Marlboro Country with a charge to continue improving profits 20% a year. But consumers are resisting high-priced cigarettes, and the Kraft cheese business has gone soft. The new CEO is dealing with some surprising problems. ■ *by Patricia Sellers*



A Navy veteran, Miles is the first non-tobacco chief of the world's largest consumer goods company.

**I AM A WORRIER,**" says Philip Morris CEO Michael Miles. "I worry whether tomorrow will be Wednesday. I worry instead of exercising." Last year, when Miles won the four-man horse race to become head of the world's largest, most profitable consumer products company, he fretted that there would be nothing left to worry about. "If there has ever been a company that looked like it didn't need fixing," he said, "Philip Morris is it."

Well, that's one thing he can stop worrying about.

Six months in the saddle, Miles is discovering that the task of producing 20% annual earnings growth—the measure of success at Philip Morris—is far more daunting now than in the recent past. His predecessor, Hamish Maxwell, hit the bull's-eye in each of the past five years, and investors expect the same marksmanship from the new man. "We're going to shoot for it," says the laconic Miles, 52, the Gary Cooper of corporate cowboys. But he is facing a different marketplace—and a much more difficult one.

**■ PROBLEM NO. 1: U.S. tobacco.** Despite Philip Morris's blockbuster acquisitions of Kraft (1988) and General Foods (1985), domestic cigarettes is still the business that puffs up profits, bringing in \$4.8 billion in operating income last year, or almost half the corporate total. Trouble is, the American cigarette industry is declining 2% to 3% a year. Much worse, smokers are switching in packs from Philip Morris's premium products—Marlboro, Merit, Virginia Slims, and Benson & Hedges—to cheaper brands with smaller profit margins. Unit sales of Marlboro, America's leading cigarette, fell 3.3% last year. Bargain brands—and Philip Morris now markets them too—are a bigger threat to investors and to that 20% goal than the product liability litigation now before the Supreme Court.

**■ PROBLEM NO. 2: The food business** is not the staple it used to be. Recession-battered consumers have changed their shopping habits. The combination of price-sensitive buyers and a narrowing of the quality gap between private-label and brand-name goods means slower sales for Kraft General Foods. KGF's North American revenues rose only 1% last year. Excluding special charges, operating income increased a disappointing 8% as the Cheese Whizzes in the Kraft U.S.A. unit—using a Miles-made strategy—missed inter-

REPORTER ASSOCIATE: Kate Ballen

nal profit targets by \$125 million. Management says that profits probably will rise less than 10% in 1992.

Miles to the rescue? Not if he can help it. Sober, self-effacing, and professional in the extreme, he dreads being viewed as change-maker or revolutionary. But he is: Miles, who ran Kraft General Foods from 1989 to 1991, is the first non-tobacco man and non-smoker to lead Philip Morris in its 145-year history. In his comments to *FORTUNE*, the first major interview since he took over, he made clear that he wants any change to come from the ranks: "I say to managers that once I've had a chance to put my 2 cents in, do what you want. Every 100th time, I will want it to be my call."

Miles does recognize that part of his job is to calm his fellow worriers. Says he: "Right now our people are operating in difficult times, and it's hard to see a lot of light at the end of the tunnel. There's a bit of a tendency to think things are going to be bad for as far out as we can see."

Bad? Many managers would love to have Miles's problems. The company earned \$3 billion last year on sales of \$48.1 billion. (The company reports \$56.5 billion, but that includes excise taxes that it collects and passes on to governments.) Philip Morris sells more than 3,000 items, including cigarettes, Kraft cheeses, Post cereals, Maxwell House coffee, Entenmann's baked goods, Toblerone chocolate, and Miller beer, which is the world's second-largest brewer yet represents only 8% of revenues. The stock has returned an average 36% to investors annually, including reinvested dividends. The value of the shares outstanding hit \$74 billion last December and has since slid to \$69 billion. That still exceeds the value of any other U.S. company except Exxon.

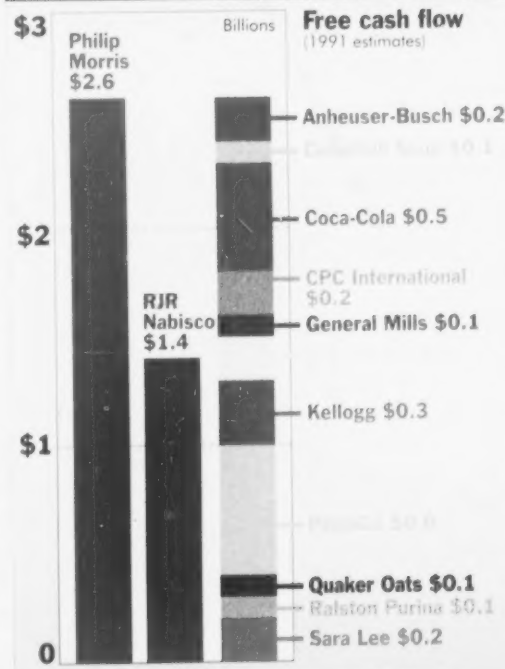
The new CEO's biggest "problem" may be deciding where to invest Philip Morris's money. The company gushes more excess cash than any other enterprise but Exxon. During the next five years, Miles figures, Philip Morris will throw off free cash of more than \$21 billion—almost \$500,000 an hour on average. This excess is the money left over after capital expenditures, dividends, and taxes—and Philip Morris can

use it either to pay for acquisitions or to buy back stock.

Miles plans to do both, and he will spend the savings a bit differently than his predecessor did. While Maxwell spent \$2.5 billion on share repurchases throughout his eight years as CEO, Miles says he probably will dole out \$2 billion over the next two years alone.

The new boss wants to use much of the rest to acquire food and tobacco operations, mostly outside the U.S. Philip Morris already has annual international revenues of \$15 billion, more than Coca-Cola,

## THE KING OF CASH



Philip Morris generates almost \$500,000 an hour—more than most food companies combined. The other big food and tobacco company, RJR Nabisco, is a distant second.

PepsiCo, and Kellogg combined. And though weakened at home, Marlboro, a \$10-billion-a-year brand worldwide, is a racehorse abroad as markets in Asia, Eastern Europe, and the former Soviet Union have opened. Says Miles: "Our international business will grow more rapidly than the domestic through the Nineties."

But for all his plans for global expansion, Miles knows only one business can keep profit growth apace with the past: U.S. tobacco.

Understanding the trouble in tobacco-

## CORPORATE PERFORMANCE

land requires knowing why the business has burned so brightly for so long: inordinate pricing power. According to the U.S. Labor Department, the tobacco industry's 10% average annual price increases over the past 11 years exceeded those of any other product, including hospital rooms and prescription drugs. Since nicotine junkies didn't seem to resist stiff price hikes, Philip Morris U.S.A.'s sales went up 9% to \$9.4 billion in 1991, and operating profits rose even faster to reach \$4.8 billion. Operating margin: a fabulous 51%, up from 42% seven years ago. Philip Morris's gains in market share are impressive too—43.3% of total U.S. cigarette sales today, vs. 35.9% in 1985.

The robust pricing showed its first signs of wobbling in the early 1980s. Smaller companies that had lost customers, such as Liggett Group and Brown & Williamson, a subsidiary of England's BAT Industries, seized on the idea of keeping their factories running by producing cheaper smokes with lower-cost tobacco and less marketing support.

Philip Morris management initially spurned the idea of selling less profitable brands but watched its smokers switching to the cheap cigarettes. "By 1985 we'd seen enough," recalls William Campbell, chief executive of Philip Morris U.S.A. "The emergence of the discount segment and

its tremendous growth are the primary events transforming our industry."

Philip Morris was itself transformed, and last year the company became the market leader in the low-priced segment. Now 17% of the cigarettes Philip Morris U.S.A. sells are discount brands, with names like Cambridge, Alpine, Bristol, and Bucks.

Trouble is, by legitimizing the category, Philip Morris seems to have created a monster. Says Emanuel Goldman, who follows the company for Paine Webber: "The discount segment has come from nowhere, from 11% of industry sales just three years ago to 25% today. The issue for Philip Morris going forward is, What is the continuing rate of growth? If the discount category goes from 25% to 30%, then to 35% or 40%, the company's ability to raise prices at historical rates may be jeopardized." If Philip Morris loses its wonderful pricing power, those terrific margins will probably fade.

Of course, the company could help profits by raising prices on the cheap brands. Last year that's exactly what Philip Morris and other tobacco marketers did. They pushed up prices of the discount smokes more than 20%, vs. 10% for full-priced cigarettes. Now, with the price gap between discount and premium brands narrowed, the "cheap" brands are not so cheap anymore, and the question is: Are consumers so price-sensitive that they will continue to trade down to less expensive labels?

Bill Campbell & Co. are trying to keep Philip Morris from living off discount brands. After spending heavily to promote Philip Morris's low-priced cigarettes in 1990 and early

1991, he is pouring money back into Merit and Marlboro. In February, Philip Morris U.S.A. launched a new version of Merit called Merit Ultima, with super-low tar and nicotine. Last summer it spent an estimated \$60 million, a record for a new cigarette, to advertise Marlboro Medium, the first offspring of that brand in 20 years.

Marlboro Medium, which is milder than traditional Marlboro but draws on smokers who find Marlboro Lights unmanly, was the idea of a woman, Nancy Brennan Lund, 39. Vice president for Marlboro, Lund had to push her concept through the layers of management for five years before the bosses relented. Recalls Campbell, 47, "A lot of us hated the name, and we said, 'Why don't you call it Marlboro Middle-of-the-Road or Marlboro Mediocre, Nancy?'" Marlboro Medium should bring in over \$750 million, hardly mediocre, in first-year revenues, and has helped reverse Marlboro's overall volume decline.

Marlboro is riding taller in the saddle than other full-priced brands, but can it continue to expand? Miles says, "We are planning to grow Marlboro volume in the U.S." Marlboro Woman Lund isn't so sure. She sees the brand's 26% domestic market share increasing, but not its volume.

**T**O PUMP UP SALES of all brands, Philip Morris is engaging in two troublesome tactics. First, it has been moving aggressively to ship extra cases into distributors' warehouses and record them as sales, a practice generally known as trade loading. Philip Morris's



Marlboro Woman Nancy Lund is the face behind the biggest brand.



The big cheese at Kraft General Foods, Mayer faces profit problems.

activity is not as dangerous as the loading that R.J. Reynolds engaged in several years ago. Reynolds, a subsidiary of RJR Nabisco, lined distributors' warehouses each month in order to hide market share declines. Quitting this behavior cost Reynolds an earnings shortfall of \$360 million in 1989, with the money spent to trim production and eliminate inventories. Today all tobacco manufacturers limit the amount of cigarettes that distributors may buy before price increases, but Philip Morris is significantly more generous than RJR.

Campbell defends the practice: "Our objective is to get Marlboro's inventory up in the stores, where we typically have a 26% share of the market but only 11% of the shelf space. We think keeping pressure on the distribution channels is a good idea." "Wrong," says a former Philip Morris executive who has studied trade loading. "Just because you load the warehouses doesn't mean more cigarettes make it into the stores. What Philip Morris is doing is a financial game to make their sales and profit targets."

The second worrisome tactic is Philip Morris's drive to sell the cheapest smokes it can make, black-and-white generics. For years the company has produced relatively small amounts of these low-profit cigarettes. You've probably seen them in unadorned packs in places like Wal-Mart, bearing such names as Best Buy, Basic, and Gridlock: The Commuter's Cigarette—in California, of course.

From 1990 to 1991, Philip Morris nearly tripled its sales of black-and-whites to 9.8 billion cigarettes, almost the volume of Marlboro Medium. Campbell's rationale: He wants to participate in every major cigarette category. And growth in black-and-whites helps him meet his goal of lifting Philip Morris's U.S. market share at least a point a year. How, though, can feeding cheap, low-profit generic cigarettes into the marketplace help profitability? Says Campbell, somewhat exasperated by the query: "What's good for the consumer is good for the industry. How do you like that? That's pretty good, isn't it?"

The test is ultimately whether Philip Morris can sell enough cigarettes at a good price to sustain U.S. tobacco's recent 14% earnings growth. Analyst Goldman consid-

## **"A tobacco victory [in the Supreme Court] could take Philip Morris's stock up 20%."**

ers the stock a strong buy but says: "They need 13% to 14% earnings growth in the domestic tobacco business to sustain 20% increases in earnings per share. That's the comfort level, though they may be able to get by with 12% growth." Campbell says that during the next few years he is shooting for "low double-digit growth in operating earnings. Some years we'll be a bit higher and some a bit lower."

Philip Morris stock, recently trading at \$75 a share, sells at 13.6 times projected earnings, trailing the market. That's partly because investors remain fixed on tobacco's legal exposure, concerned that an important Supreme Court ruling, expected by this summer, will go against the industry. The market is probably overreacting. The Supreme Court will decide whether the federally mandated warning labels that began appearing on cigarette packs in 1966 bar related claims in state courts.

Analysts who have studied the situation say a ruling for the plaintiff, Rose Cipollone, simply would mean more individuals will file suit. No tobacco company has ever lost a liability case or paid a penny to settle, juries being of the opinion that smokers have been adequately warned that cigarettes can ruin their health. Says John McMillin of Prudential Securities: "A Supreme Court ruling against the industry has limited downside for the stock because worries have already pulled down the price. A tobacco victory could mean the end of major litigation risk and take Philip Morris's stock up 15% to 20%."

Where, you may ask, is Miles amidst the difficulties? Keeping his nose out of tobacco. Not exactly a wander-the-halls manager, Miles remains a mystery man to the rank-and-file at Philip Morris U.S.A. A new cost-cutting program there prompted rumors that the humorless food guy had ridden into Marlboro

Country to spoil the free-spending fun. Says Miles: "Absolutely wrong. All of the adjustments or cuts or whatever word you want to use have been initiated by Bill Campbell and Philip Morris U.S.A."

By eliminating layers of plant management and reducing overhead at headquarters, Campbell plans to save \$75 million, a modest 1% of costs this year, though there is surely more pain to come. Campbell appears to be a more hard-boiled boss than Miles: "The don't-fix-it mentality is what got IBM, General Motors, and Sears in trouble," he says. "They didn't fall apart from a blowout. They're dying from a slow leak. Contrast their approach with the Japanese model of continuous improvement."

**M**ILES'S ROLE as cool observer of Campbell's action plan is no surprise given his history. Straight out of Northwestern University's Medill School of Journalism, where he majored in advertising, Miles joined ad agency Leo Burnett and was known there for a logical, rational approach. "Good advertising is advertising that sells, period. Just the facts, ma'am," he says today. Hicks Waldron, former chairman of Heublein, which hired Miles away from Burnett at age 31, says, "Mike was the most professional thing I had come across



Australian Geoffrey Bible runs food and tobacco abroad.



The cowboy rides high in Turkey. Philip Morris sells 90% of all imported cigarettes there.

in a long time. His creativity is that he can sort out the creative ideas of others rather than come up with them himself." Miles turned around Heublein's Kentucky Fried Chicken chain by devising a strategy that emphasized quality and service, and at Kraft he perked up the marketing by pushing new products. Miles hits his desk by 7 A.M. and thinks about business every minute of his life. Even in his sleep, some say.

Composed, even icy at times, Miles leaves underlings wondering what he is really thinking. At meetings with managers, he speaks sparingly, preferring to offer his "2 cents," short and concise, on paper later. He explains, "Decision-making authority should be as close to the actual implementation as possible." At parties he abhors small talk and often settles in a corner chair, alone.

**S**OMETIMES his sobriety and rationality appear extreme. During a rare social excursion five years ago, he went rafting in British Columbia with 11 other executives. When the raft flipped in fast-moving rapids, five of his companions died. Asked whether the accident has affected the way he views life or his work, Miles says, "No, it hasn't. It was obviously a terrible tragedy for families involved with the fatalities and a watershed experience for the two or three people who were carried a long way down the river and survived. I actually was in the water for less than two minutes and got out quickly and

never worried about being rescued. As I look back on it, it was as bizarre a twist of fate as jaywalking across Park Avenue and having the person next to you get run over. For me personally, it wasn't that traumatic an event in my life." He adds: "I once had a garden tractor almost roll over on me. That scared me."

As head of Kraft General Foods, formed after Philip Morris bought Kraft, Miles made Hamish Maxwell's diversification strategy work. Up to that time, top managers at General Foods, acquired three years earlier, had resented their parent and insisted that old brands like Maxwell House and Post could not increase sales very much.

Miles stressed growth and revamped advertising. Today at the once laggard General Foods U.S.A., sales of leading products such as Kool-Aid, Jell-O, and Grape Nuts cereal are expanding again. Operating profits rose to more than \$700 million last year, vs. \$433 million in 1989.

But, of all things, Kraft's cheese division turned soft, the aftermath of bad pricing decisions made under Miles's leadership. During the past two years, prices for milk—the cost of goods in cheese, of course—turned volatile, and while private-label cheese producers kept their prices down, Kraft

priced its products much higher. As Miles explains, the steep pricing was a remnant of an expensive anti-takeover plan that he and Kraft management devised before the hostile bid by Philip Morris. The plan called for extremely high returns in cheese, and, once ensconced in the Philip Morris fold, Kraft stuck to the aggressive targets. Cheese margins were supposed to improve from the low teens to the high teens.

Clearly, Kraft managers outfoxed themselves. The private-label brands devoured chunks of the U.S. cheese market. By the time Kraft started slicing prices last year—as much as 14% on Cracker Barrel—retailers were living quite nicely off their store brands. In some cases, say industry analysts, they refused to pass on Kraft's price cuts to consumers. The pricing foibles led to last year's \$125 million—at least 20%—shortfall in expected cheese profits.

Now the food marketers, like the folks at Philip Morris U.S.A., acknowledge that pricing their way to high profits is a luxury of the past. Richard Mayer, who took over KGF North America when Miles became the parent's CEO, says that he expects General Foods' operating income to be up more than 15% as its recovery rolls ahead, but Kraft's prices and profits will likely be flat. "We need to do what is necessary to make sure America continues to spell cheese K-R-A-F-T," says Mayer, 52, a friend of Miles from their Heublein days. He continues: "We're not viewing this recession as a short-term phenomenon. We see a much more price-sensitive consumer, a narrowing of the quality gap between private-label and branded manufacturers' goods, and profound changes in the retail trade toward low-price operators."

Misreading consumer demand led KGF to overbuild, and a \$455 million pretax write-off against 1991 earnings will cover the cost of some plant closings. Now Mayer is preaching volume growth. "Without it a company doesn't have a long-term future," he says. He is driving the message home by revamping compensation to emphasize revenue and market share goals more than profit targets.

Kraft's product line doesn't exactly scream growth, however. Mayonnaise and macaroni-and-cheese dinners are not on the shopping lists of fat-phobic, convenience-oriented shop-

**"We're not viewing this recession as a short-term phenomenon." Consumers have changed.**

pers. Although KGF sells more low-fat and fat-free versions of its foods than any other company, future growth from these better-for-you products "will not be transforming," as Mayer says, using a favorite corporate expression.

Moreover, marketing spending is not flowing so freely. Flush with cost savings from combining Kraft and General Foods, Miles jacked up marketing expenses 23% in 1990 and 16% in 1991. But this year they will be virtually flat.

Mayer has two ideas that he believes can "transform" Kraft General Foods—or at least provide a competitive edge. The first is to get market research and computer people working in teams with brand managers so that everyone better interprets the zillions of sales data generated by super-market scanners. The strategy should help the company respond quickly to competitors' moves.

The other big idea is to distribute all KGF products within a particular region from a single warehouse. The logic: to serve customers better. Retailers typically buy 10% of all their grocery items from KGF but draw from many different warehouses. Last fall in Norcross, Georgia, near Atlanta, KGF set up its first one-stop-shopping center in a warehouse formerly used for General Electric air conditioners.

Once fully rigged with KGF's computer gear, the center probably will be the largest and most sophisticated food warehouse in the country. Notes Miles: "Norcross is what I hope all productivity activities are: efficiency inextricably linked to quality."

Though his domestic table is modest, Miles can feast on Philip Morris's international opportunities. Consider: The market for cigarettes outside the U.S. in 1980 was 3.9 trillion units, and only 40% was open to Western companies. Today consumers abroad are smoking 4.9 trillion cigarettes a year, and the relaxation of trade barriers in places like Japan, Eastern Europe, and to some extent China gives Philip Morris a chance to reach 95% of those smokers.

Says Geoffrey Bible, who heads international food and tobacco: "We have moved from a potential market of 1.6 trillion cigarettes to one of more than 4.6 trillion units." Philip Morris sold 640 billion, or 11.6%, of the world's cigarettes last year. That makes the company the

## PHILIP MORRIS



The stock stopped smoking after a decline in net income in 1991. Earnings rose 21% before a restructuring charge and an accounting adjustment.

**SALES** (latest four quarters) **\$48.1 billion**  
Change from year earlier Up 8.4%

**NET PROFIT** **\$3.0 billion**  
Down 15.1%

**RETURN ON EQUITY** **24.0%**

**TOTAL RETURN TO INVESTORS** **35.6%**  
2/27/87-2/28/92 (annual rate)

**PRICE/EARNINGS MULTIPLE** **23.0**

**DIVIDEND YIELD** **2.4%**

second-largest seller behind the Chinese government, which in 1991 churned out over 1.5 trillion. Philip Morris, though, is the fastest-growing producer by far. And the most profitable. And the best-positioned to seize market opportunities.

**T**HE COMPANY'S global strength developed from domestic weakness. A feeble No. 6 among U.S. tobacco sellers during the 1950s, Philip Morris was so desperate to attract customers that it started selling its cigarettes in duty-free shops in foreign countries where Americans liked to travel. While R.J. Reynolds, then the U.S. market leader, focused on its Camel and Winston brands domestically, Philip Morris hired international managers and licensed its cigarettes in markets closed to imports.

One interesting byproduct of this early internationalism is a senior operating management more global than most companies'. While Miles and Mayer are Americans by birth, former CEO Maxwell is a Scot. Bill Campbell is Canadian, and David Dangoor, Philip Morris U.S.A.'s marketing boss, is an Iranian schooled in Sweden. Two of the three bosses Miles beat for the CEO spot are Australian: Bible, the international chief, and William Murray, president and chief operating officer. The third is chief financial officer Hans Storr, from Germany. He trots the globe shopping for the cheapest loans.

One of Philip Morris's biggest challenges abroad is penetrating markets where govern-

ments control prices, levy huge taxes, and even peddle their own brands. How do you deal with the Taiwanese government's Long Life cigarettes and the Japanese monopoly's Dean—for James Dean? Says Bible: "We find it's better to work with the governments, vs. playing their fierce opponent."

Easier said than done. Last year in Hong Kong a 200% tax increase on imported cigarettes doubled the price of a pack of Marlboro and sent Philip Morris's sales sliding 80%. After employees and friends gathered 75,000 signatures of huffy smokers, officials cut the tax in half.

In Italy, the company got tangled in a government crackdown on illegal cigarette imports that avoid high Italian taxes. Italy imposed a one-month ban on Marlboro, Merit, and Muratti, a popular local blend, after these brands were seized in an eight-ton truckload of bootlegged butts near the northern border. The company's protest that it can't control bootleggers fell on deaf ears. Bible says that he and Alcardo Buzzi, chief of Philip Morris's international tobacco operations, spent two weeks negotiating a truce with officials. Philip Morris agreed to mark Italian-bound cigarettes to distinguish them from illegal products.

International tobacco's profit margins are half those 51% returns in the U.S. But ample gains—profits rose 24% in 1991 on a 14% increase in revenues—encourage managers to invest more. The question, of course, is where. Walter Thoma, who runs Philip Morris's tobacco operations in the European Community, says he wants to build "a huge factory" because his sales volume has risen 25% during the past three years.

Hearing that, CFO Storr rolls his eyes and plays penny-wise banker: "If you give all of these operating managers who want to build state-of-the-art plants everything on their wish list, we'd have no free cash." Storr is opening the corporate purse for expansion eastward.

Last month in Turkey, which management views as "the gateway to the east"—meaning Central Asia and the former Soviet Union—Philip Morris broke ground on a \$400 million cigarette factory. Because of taxes, Marlboros cost twice as much as the government's brands, but Turkish officials agreed to lower levies once Philip Morris begins manufacturing, probably next year.

Philip Morris in 1990 also bought three deteriorating East German factories that churn out the leading local cigarette, F6. Instead of toning down the taste and spiffing

**"We have moved from a potential market of 1.6 trillion cigarettes to more than 4.6 trillion."**

Dancing Drama Computers Ballet Skiing

Opera Art Rafting Canoeing Cycling

WE

Diving Zoology Travel Languages Theater

Making Movies Sailing Baseball Make-Up

Archery Acting Interior Design Fashion

DONT

Carpentry French Cooking Weaving

Water-Skiing Snorkeling Horseback

Riding Surfing Astronomy Creative Writing

Modeling Auto Repair Plumbing Running

INTERRUPT

Business Making A Record Basketball

Painting Pottery Gymnastics Mime

Careers Counseling Karate Softball

Swimming Golf Roller-Skating Ice-Skating

FUN

Debating Sculpture Bowling Badminton

Amusement Parks Archeology Juggling

Dressmaking Rowing Ecology

Whale Watching White-Water Rafting

COMMERCIAL

Dancing Drama Computers Ballet Skiing

Opera Art Rafting Canoeing Cycling

Diving Zoology Travel Languages Theater

Making Movies Sailing Baseball Make-Up

Archery Acting Interior Design Fashion

Carpentry French Cooking Weaving

BREAKS.

THE GIRL SCOUTS

AS GREAT AS YOU WANT TO MAKE IT

## CORPORATE PERFORMANCE

up the package—as some competitors did with East German brands that they acquired—Philip Morris kept F6 the same. By not Westernizing the harsh, high-tar cigarettes, the company improved F6's market share to about 35% from 27%. In less than a year Philip Morris earned a profit on its estimated \$20 million investment.

To meet high demand for exports, Philip Morris is even adding \$400 million in new capacity stateside, at its Cabarrus, North Carolina, factory. Last year the company shipped 22 billion cigarettes to the former Soviet Union, its largest order ever and equal to one-tenth of its U.S. volume. By 1997 management wants to sell 80 billion to 100 billion cigarettes a year in the former Soviet Union. Philip Morris barter its cigarettes for products—probably gold and oil, though management will not say—that are readily exchangeable for dollars. That way, it takes hard currency out of the market and even earns a profit—an estimated \$75 million last year.

The cigarette seller's strides abroad get a food marketer's heart beating wildly. Says Miles: "When you see the enormous success the international tobacco company has had, it provides that much more inspiration for our food managers to stick with the fight, to chase the opportunity. And inspiration is a very important part of what motivates people."

Every Philip Morris watcher wants to know: Where will Miles next drop his big bag of cash? "I can tell you that we would not go outside consumer packaged goods, for sure. We're focused primarily on international," says the boss. Since acquisition opportunities in tobacco are limited, figure on food, probably in Western Europe, within the coming year or so. In 1990 Philip Morris bought one of Europe's largest coffee and chocolate companies, Jacobs Suchard, well known for those Alp-angled, nougat-specked Toblerone candy bars. The \$4.1 billion deal made Philip Morris the third-largest food marketer in Europe, behind Nestlé and Unilever. Says Bible: "Our revenues today are approaching \$10 billion in food, and Nestlé has about \$15 billion in European sales. But with acquisitions, we'll grow faster than they will. We'll be on Nestlé's tail."

At Kraft, Miles kept a short list of acqui-

sition targets, and some of the same companies are believed to be on his list today. One is H.J. Heinz, a European powerhouse. But Miles figures that CEO Tony O'Reilly has squeezed costs so dutifully that post-acquisition savings would be too slight to make a deal worthwhile.

"I would be willing to do a hostile bid for a company," says Miles. "The Kraft acquisition started off as hostile and ended up officially, I guess, hostile. And the people of Kraft have learned that being part of this larger family can be very good."

Is PepsiCo a target? Doubtful, for Philip Morris professes no love for a No. 2 soft drink player. Cadbury Schweppes would give Philip Morris a bigger bite of European chocolate. Says Bible: "Yes, but only in Britain." CPC International? "I'm not looking at it," he says. The best catch: Paris-based BSN, which would help Philip Morris get the French, who cannot fathom Velveeta, to at least taste its other cheeses, such as Cracker Barrel and Kraft Natural. Says Bible: "Their government would never let us buy BSN."

Successful acquisitions are crucial to Philip Morris, and to Miles, whose hotshot reputation is at stake. If the company expands operating earnings around 15% each year, it can still raise per share net income at that magical 20% rate by borrowing heavily for acquisitions, then tapping the cash-flow fountain to rapidly pay back debt. That way interest costs go down quickly.

**C**AN MILES keep up the pace? To do so might require \$85 billion in sales by 1995, with net income of \$9 billion. That will mean buying businesses abroad that provide good returns and keeping domestic operations healthy enough to pay for the acquisitions.

Philip Morris U.S.A. and KGF North America, the source of more than two-thirds of corporate profits, have serious pricing problems and growth difficulties. But managers are busily working on them. If problems persist and the 20% profit growth goal becomes elusive, don't be surprised if Miles proves himself a man of action. Though comfortable amidst the worries, he may throw in more than just his 2 cents, and play the revolutionary more than he ever intended. **F**

**Everyone  
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to know:  
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Miles next  
drop his  
big bag  
of cash?**